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Filling the gaps

Corporations in the UK are increasingly turning to intellectual property assets to reduce expanding pension deficits. Stuart Whitwell looks at whether the technique could spread to Europe and explains why legal advice is crucial to the strategy's success

Reducing pension deficits is a major priority for large corporations. They are a drag on the share price, a hindrance on potential merger or acquisition deals and bank lending, consume vast amounts of cash (in contributions and pension protection funds), and direct management attention and resource away from the core issue of running the company.

A ruling at the end of last year in the UK's High Court will potentially improve pension deficit positions, as the judges ruled in favour of the pensions regulator in its dispute with the administrators of Nortel Networks and Lehman Brothers. The ruling places the pension liability onus of an insolvent group company on remaining group companies throughout the world. It also prioritises the pension deficit payment over other unsecured liabilities such as bank loans, by making it an administration expense.

Deep deficits

The issue arose because the regulator stipulated that the nine remaining solvent Nortel companies were liable for the £2.1billion (€2.4 billion) pension deficit that arose following 18 Nortel companies entering administration. The administrators of Lehman Brothers had a similar issue with the regulator demanding £130 million (€148 million). Nortel and Lehman issued joint proceedings but lost, although they have been given leave to appeal.

In the UK 3,675, or 56 per cent, of defined benefit pension schemes were in deficit in March 2011 according to the Pension Protection Fund, with a combined deficit of £48.8 billion (€55.6 billion). The situation in Europe – and indeed the rest of the world – is similar. Analysis of FTSE Global 100's company pension disclosures from the European Pensions Briefing 2010 by London-based actuarial consultancy LCP reveal a combined deficit of €154 billion with substantial deficits throughout EU countries. LCP also calculates that over the three years to 31 December 2009, the FTSE Global 100 companies contributed €90 billion into their schemes yet saw deficits climb by a similar amount.

Intangible assets are increasingly attractive as they are generally free of existing obligations – unlike property, which often has loans secured against it

The following year, 2010, saw many companies use an innovative form of pension management strategy to reduce and manage their pension deficits: non-cash assets. Non-cash assets can either be contributed directly to the pension fund or held as a contingent security payment. In the UK, an estimated £8 billion (€9.12 billion) of non-cash asset deals were carried out in 2010 compared to £12 billion (€13.7 billion) of cash payments. This is forecast to increase in 2011 with a third of the FTSE 100 considering non-cash financing solutions and an estimated £10 billion (€11.4 billion) forecast for this year.

Physical property

Many assets have been used and are suitable for such schemes. The majority include physical property but an increasing proportion are using intellectual property (IP), such as shares, contracts, trademarks and associated royalty payments. Intangible assets are increasingly attractive as they are generally free of existing obligations – unlike property, which often has loans secured against it. IP is also relatively simple to identify and separate, and it can be extremely valuable, can be valued reliably and provides solid and marketable security to trustees. Legal structures underpin these arrangements and the trend to use IP is set to continue throughout 2011.

Some physical property examples of non-cash asset funding include:

- Marks & Spencer has transferred property valued at approximately £1.1 billion (€1.25 billion) to it pension fund in three tranches, in 2007, 2008 and May 2010.
- Department store John Lewis transferred property worth £150 million (€171 million) in January 2010 with trustees receiving rental payments for

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21 years followed by a bullet payment of between £0.5 million (€0.57 million) and £99 million (€113 million) depending on funding levels.

- Restaurant and hotel owners Whitbread provided £228 million (€260 million) of property and other assets in May 2010 with trustees receiving income for 15 years followed by a bullet payment to remove any remaining deficit up to a value of £110 million (€125.4 million).
- Supermarket chain Sainsbury's transferred £750 million (€855 million) of property to its pension fund in May 2010 providing an annual income of £35 million (€40 million) for 20 years and bullet payment up to £600 million (€684 million).
- Builders' merchants Travis Perkins transferred 16 properties in June 2010 into its scheme with trustees receiving rental yields for up to 20 years.

Examples of intellectual property include loan notes, contracts, shares and trademarks. In the first category, at the beginning of last year, the bank Lloyds transferred £5 billion (€5.7 billion) of assets in the form of notes in the group's securitisation programme with trustees receiving £215 million (€245 million) a year over five years.

In the contracts category, construction company Interserve transferred 13 public finance investment contracts in December 2009 worth £61.5 million (€70 million) to reduce its deficit of £250 million (€285 million).

In relation to shares, media business ITV transferred its digital terrestrial television licence-holding company, SND, to its pension fund with trustees in May 2010 receiving £8.4 million (€9.6 million) a year for 12 years and a bullet payment to remove any remaining deficit up to £150 million (€171 million). And food business Uniq ceded 90 per cent of its shares, worth about £9 million (€10.3 million), to its pension fund in March 2010 to relieve the company of its £400 million (€4.56 million) pension deficit.

Regarding trademarks, engineering company GKN transferred £331million (€377 million) of assets including property and trademarks in March 2010 with trustees receiving £30 million (€34.2 million) a year for 20 years. And drinks company Diageo transferred maturing whisky stocks worth about £500 million (€570 million) in July 2010 for which trustees receive £25 million (€28.5 million) a year for 15 years with a maximum bullet payment of £430 million (€490 million).

Legal structures

The legal structures of these arrangements are based around allowing a company to continue using an asset while providing either ownership of the asset or rights to the asset to the pension fund. The most common structure uses Scottish limited liability partnerships to house assets. These are attractive because having a separate corporate identity from the company avoids the vehicle being classified as a collective investment, which is restricted under pension guidelines. This also enables the sponsor to benefit from an accelerated corporation tax relief – a consequence of contributing many years worth of payments in one go. This can be a considerable amount if the asset is valued at many millions as most schemes so far have been. This benefit can only be realised if the correct structure is put in place and implemented.

An alternative structure is to have two special purpose vehicles (SPV's). The sponsor pays a royalty fee to limited liability partnership 1 for use of the asset and a guaranteed profit share similar to a bond coupon is paid to the pension scheme. This has the advantage of providing additional security to the pension scheme and trustees because it often leaves headroom

Deficits by country/region

Country/region	2009 deficit €m	2008 deficit €m
USA & Canda	58,569	66,604
UK	21,161	19,745
Other EU	18,177	18,219
Germany	17,352	13,750
Asia Pacific	15,627	3,761
France	14,078	13,171
Switzerland	5,971	6,949
Netherlands	3,223	6,089
Middle East	119	129

Largest deficits

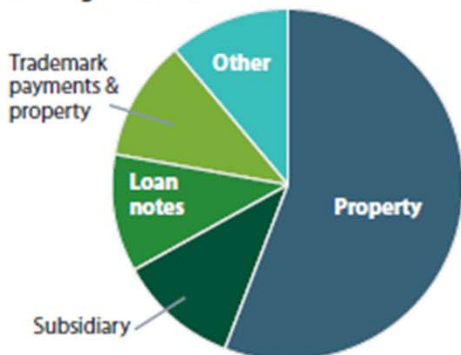
Company	2009 deficit €m	2008 deficit €m
Banco Santander	9,189	9,090
ExxonMobil	8,126	10,901
Axa	6,587	6,278
GE	6,069	4,832
Daimler	5,905	4,934
Bayer	5,881	5,388

Largest deficits compared to market capitalisation

Company	Deficit/market cap %
Axa	18%
Boeing	16%
Daimler	15%
Panasonic Corporation	13%
Bayer	13%
BBVA	12%

Source: LCP European Pensions Briefing 2010

Types of assets used in asset-backed funding structures



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between the underlying value of the royalty and the coupon.

The legal structures will alter depending on the nature of the asset, the circumstances and the requirements of the scheme trustees.

The first step in the process relating to the use of intellectual property is to identify which assets to include in a bundle to maintain value and security. For instance, if Bayer wanted to use some of its IP to reduce its €5.9 billion (€6.7 billion) pension deficit it would need to bundle together the obvious assets, such as patent and trademarks for drugs such as Aspirin, Alka-Seltzer and Rennie, and it may also need to consider including others such as customer contracts and supply contracts.

If L'Oréal wanted to reduce its €1 billion (€1.14 billion) pension deficit using intellectual property from brands such as Garnier, Lancôme and Cacharel it would need to include trademarks, design rights, copyright, scent recipes, and connected assets such as domain names and social media sites.

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Valuation

On identification of the bundle of IP assets – collectively called the brand – the next stage is valuation. Valuing brands is similar to valuing most other assets and should be carried out by an independent valuation specialist. There are many international guidelines valuers adhere to, such as those issued by professional and standard setting bodies such as International Financial Reporting Standards, Appraisal Standards Board, International Valuation Standards Council and the standard issued at the end of 2010 by International Organisation for Standardisation, ISO 10668, Brand Valuation.

There are three key approaches to valuing brands, the income, market and cost approaches. A combination of all three is generally used to produce a rounded, thoroughly benchmarked valuation:

- The income approach calculates the present value of future cash flows attributed to the brand, normally using the relief-from-royalty approach with an appreciation of how this fits with the firm's profitability. This calculates the amount the brand owner is relieved from paying to use its brand – by licensing it from a third party – because it already owns it.
- The market approach compares the brand with similar transactions and value references in the market, and adjusts these for parity. This is particularly relevant in these circumstances as the value the brand is transferred at would need to be closely reconciled with the value the trustees could gain for the brand if they needed to take control of the asset and sell it, in either a distressed or controlled situation.
- The cost approach looks at amount invested in building the asset and the cost required to replace it. This is generally not suitable for established brands but can serve as a useful reference point and is more appropriate for early stage brands or IP such as patents.

An important part of the valuation process is analysing market conditions, the competitive situation, potential acquirers and exit strategies, consumer behaviour, the threats facing the business and industry, and looking at how similar assets have been treated in a variety of circumstances. This is to ensure sufficient protection and headroom is put in place to preserve security for the trustees and scheme beneficiaries.

Actuarial services need to be involved representing the interests of the different pension schemes and the corporate sponsor. Pension fund investment advisors including actuaries and covenant review advisors need to consider the cash position of the fund including the suitability of the specific asset of the fund, taking into account risks, values and obligations.

Tax implications

There are several tax implications to consider when implementing these schemes. There is a potential for an exit charge to be triggered for capital gains tax purposes, as such the legal ownership needs to remain within the group. It is possible to avoid triggering such a liability, especially in circumstances where the purpose of the asset transfer is to benefit the sponsor's pension scheme, but this should be considered when establishing the structure. Royalty payments are made to the special purpose vehicle at arm's length values in use. There are tax benefits to the corporate based on accelerated contributions which are tax deductable.

The legal role is crucial to the whole process as this is what binds the scheme together. Legal rights to be collected

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for the different types of IP and other connected assets. A consideration of the registered and unregistered rights to the IP is a requirement of the new brand valuation ISO standard so involvement is necessary here.

Agreements need to be drafted to transfer the assets or rights to the assets into the appropriate SPV. The articles and ownership of the SPVs need to be confirmed and the royalty licences also need to be created. Agreements also need to be constructed to monitor the ongoing asset values such that if the values fall below a certain point, a mechanism is triggered to transfer the asset back to the corporate in exchange for cash that has been held for that specific purpose.

Diageo contributed £500 million (€570 million) of whisky stocks, not because it needed to reduce cash payments, but to avoid paying too much into the scheme as asset values were artificially low and liabilities high, thereby exaggerating the deficit position

Communication

These different components do not happen in isolation. The key to the whole exercise is communication between advisors, corporate and trustees. Each area connects with the others so it is crucial that an open dialogue is maintained throughout to ensure a beneficial outcome for both the corporate body and the trustees.

These schemes can be promoted by both the pension fund and the corporate as there are significant benefits to both parties, including:

- As IP is only recognised on a balance sheet following acquisition – and then generally undervalued and out-of-date – using brands and IP is an effective way to leverage the capital value of the asset and communicate this to shareholders.
- The deficit is immediately reduced by the value of the assets contributed to the pension fund.
- The reduced deficit lowers the scheme's PPF levy payments, which the sponsor generally pays.
- The contributions are lowered as the IP is transferred in lieu of cash as the deficit payments are spread over a longer period.
- Cash flow is significantly enhanced, which puts the company in a better position to finance operations.
- The share price could increase with the more effective management of what was a significant liability.
- There is an accelerated corporation tax benefit as future contributions are made in one lump sum. This can be a considerable amount and a big incentive.
- Forcing management to pay to use the IP through royalty payments, which it was previously using for free, focuses attention resulting in more effective brand management.

There are also a range of benefits to trustees and pension funds, including:

- The key benefit for trustees is the security they now have over a group of assets they can sell in event of default. This security is enhanced because the IP is generally transferred at a default value, so a significant discount to the value in use.
- There is an immediate reduction in the deficit.
- The sponsor company – which the trustees rely on for contributions – is in a much healthier position and more likely to be able to meet its ongoing obligations.

Security

One of the key considerations is balancing the pension fund's cash requirements and the need for security. These are the most sensitive points, requiring compromise, negotiation and a full understanding and evaluation of the situation.

What assets and companies are suitable? All forms of IP that are separable, marketable and can be valued robustly are suitable for these schemes. Most companies are rich in IP, be it patents, copyright, brands and trademarks, software, technology, databases and customer lists or designs.

These schemes are not used for companies at financial risk, they are an effective pension and cash management strategy. Diageo, for example, contributed £500 million (€570 million) of whisky stocks, not because it needed to reduce cash payments, but to avoid paying too much into the scheme as asset values were artificially low and liabilities high, thereby exaggerating the deficit position. Removing non-cash assets from a scheme is easier than extracting cash.

As with investments in any asset, continual monitoring is necessary to ensure value is being maintained. Information to value IP is usually conducted routinely by the sponsor company so this can be an efficient process.

Legal involvement is pivotal in establishing these schemes. With pension deficit reduction and de-risking very much a priority for companies and trustees, non-cash asset and contingent asset funding using IP can be a win-win situation for both sponsors and trustees.

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